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The September G-5 Meeting and Its Impact

The dollar has declined dramatically since the September 22 meeting of the so-called "Group of Five" or G-5 countries — which consists of France, Japan, the Federal Republic of Germany, the United Kingdom and the United States. The G-5 meets informally to discuss sensitive international monetary problems. A communique issued after the meeting prominently discussed group efforts to resist protectionism and to improve the international coordination of macroeconomic policies, but markets have tended to focus on aspects involving official foreign exchange market intervention. This *Letter* examines the G-5 communique and discusses some of the subsequent developments, particularly with regard to the exchange value of the dollar.

The G-5 communique

In their communique, the G-5 countries stated that policy initiatives taken by them had led to a greater convergence of economic performance across their countries. But, they added, exchange markets had not fully reflected recent changes in the countries' fundamental economic conditions and their policy commitments for the future.

Against this background, the participants committed themselves to policies that would provide balanced noninflationary growth and more open markets, as well as policies that would further reduce government budget deficits in countries where they were deemed to be too high. They also stated that, given the change in fundamentals such as output growth and interest rates, "... some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when it would be helpful to do so."

In the specific policy statements contained in the communique, all five countries agreed to resist protectionism. In addition, France, Germany and the United Kingdom stated that they would reduce taxes. France, Germany, Japan and the United Kingdom said they would work toward making financial markets more efficient, and Germany and the U.K. added that they would review policies affecting labor markets. The French, German, British and American representatives also stated that they would reduce the share of the public sector in their economies.

In view of the subsequent developments discussed below, it is also noteworthy that, in the individual statements made by each country, only Japan mentioned exchange rates explicitly. Part of the Japanese statement reads, "... the government of Japan will ... (pursue) ... Flexible management of monetary policy with due attention to the yen rate."

Overall, then, two issues appear to stand out in the G-5 agreement. First, there is the question of what macroeconomic policy initiatives the G-5 countries will undertake and the extent to which such initiatives will be coordinated with one another. The second issue concerns the extent to which exchange market intervention will be employed to re-align currency values.

International policy coordination

In examining the policy measures outlined in the communique as well as the subsequent steps undertaken by the G-5 countries, it is instructive to consider the conditions of their economies in the period preceding the release of the communique. The discussion of steps to improve labor market efficiency by Britain and Germany is understandable since the gradual increase in their unemployment rates despite relatively healthy GNP growth rates suggests that their labor markets suffer from structural problems. Inflation rates in France over the past year or so have tended to be higher than those in the other G-5 countries, so the French have stated that they will pursue monetary targets consistent with decelerating inflation.

The Japanese economy has been doing considerably better than the others in terms of both output and employment. However, to a substantial extent, its relative success has been due to strong growth in exports. Thus, measures announced by Japan shortly after the meeting are meant to lead to more open domestic markets and to stimulate domestic demand. The latter set of measures is aimed at boosting private spending on housing, increasing spending by local governments and by natural gas and electric companies, and at making it somewhat easier for consumers to obtain credit. However, it should be pointed out that these measures were planned even before the September 22 meeting. Furthermore, analysts have stated that this set of measures will not have a substantial impact on Japanese domestic demand.

No significant new policy initiatives have been announced by the European members of the G-5 after the meeting. German officials have subsequently stated that the September 22 meeting would not lead to any change in their current fiscal policy. They declined to speed up the implementation of tax cuts originally scheduled for 1986 and early 1988. Some observers have been considerably pessimistic about the prospects for fiscal policy coordination among the G-5 countries, stating that the countries are unlikely to coordinate policies over a sustained period because this would mean sacrificing their domestic macro-policy objectives.

Why are the European countries apparently not eager to stimulate their domestic economies, given their recent progress against inflation and continuing problems with unemployment? Expansionary monetary policy is ruled out by the fact that it is likely to lead to a decline in the value of their currencies against the dollar. The resistance to a more expansionary fiscal policy may arise because of a growing conviction that a large government sector imposes costs upon the economy. Increases in government spending without tax increases will lead to large deficits that are likely to raise interest rates, whereas increases in government spending matched by higher taxes will tend to discourage investment as well as labor efforts.

In this context, it should be noted that the ratio of total government expenditure (which includes central and local governments and social security institutions) to GNP is already at least a third as high again for the European members of the G-5 countries as it is for the U.S. Among the G-5 countries, France had the highest proportion of government expenditures to GNP in 1984 — 52.4 percent versus 34.3 percent for the U.S.

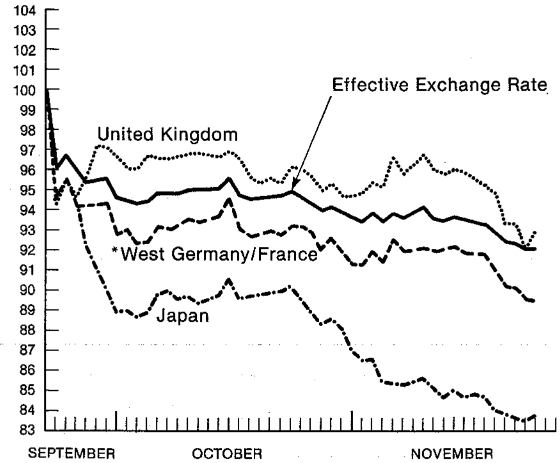
Intervention and the dollar's value
Based on the events discussed above, the consensus among financial market analysts appears to be that the only new thing to have come out of the G-5 meeting is the increased emphasis on foreign exchange market intervention. Foreign exchange traders have stated that the central banks of the G-5 countries have intervened on several occasions since the September 22 agreement. The behavior of the dollar since then is shown in the chart. (The effective exchange rate index shown in the chart is a bilateral trade-weighted index. This index selects those countries with which the U.S. has the largest total trade — value of exports plus imports — and assigns weights to the dollar exchange rates of their currencies in proportion to their shares in U.S. bilateral trade during a base period.) Notice that the dollar declined by approximately 4 percent the next day — the largest one-day decline in the floating exchange rate era.

The central banks of the G-5 countries are reported to have intervened heavily immediately after the communique was released. Foreign exchange traders report that substantial intervention also took place during the middle of October, when the dollar appeared to be strengthening somewhat. In that episode, central banks took advantage of the weaker-than-expected third quarter U.S. GNP figures which were released on the 17th of October.

Dollar-yen rate
The chart also plots the value of the dollar against the currencies of the other G-5 countries. An interesting fact evident in the chart is that the dollar has fallen most against the yen. A combination of dollar sales and policy announcements by Japanese officials have succeeded in driving the dollar down more than 15 percent against the yen.

For instance, in the last week of October, a statement by the Governor of the Bank of Japan that he favored higher interest rates was reported to have sent Japanese bond yields up more than 50 basis points. The three-month Euro-yen rate, which had remained at a near constant 6.30 - 6.50 percent for at least two years, has increased from 6.44 percent on October 18 to 8.06 percent on November 15. Similarly, in the first week of November, when the Governor made a statement saying the yen should climb higher, the yen rose by 2.5 percent against the dollar in a 24-hour period. The 15 percent decline in the value of the dollar against the yen from September 22 to November 20 compares with a

Exchange Value of the Dollar
September 20, 1985 = 100



* A single line is used to represent the value of the dollar against both the West German mark and the French franc because these two European currencies have moved very closely together over the period shown.

fall in the trade-weighted value of the dollar of 6.6 percent over the same period.

Because of these developments, market analysts have become convinced that the G-5 agreement and the subsequent intervention have been directed primarily towards reducing the value of the dollar against the yen. Shortly after the communique was issued, one observer interpreted the G-5 agreement as evidence that the other G-5 countries had been successful in pressuring Japan to make efforts to reduce its trade surplus (both via monetary and fiscal policy).

In this context, it should also be noted that market participants generally agree that one of the major (if not the primary) motivations for the G-5 agreement was to reduce the mounting protectionist pressures in the U.S., especially those in relation to Japan. As of now, the G-5 agreement appears to have been at least partially successful.

Impact of intervention

As mentioned above, the dollar has dropped by more than 6 percent since the G-5 announcement. While intervention may have been an important influence, it is likely that other factors have played important roles as well. In particular, over the past year or so, evidence of the U.S. economy's weakness has been mounting. Furthermore, real interest rate differentials between the U.S. and the rest of the world have narrowed. It is difficult, however, to determine the relative significance of these developments for the decline in the dollar.

Even if intervention has played an important role in reducing the value of the dollar since the agreement, there still remains the question of how effective intervention can be in the long-run. In the short-run, intervention creates considerable uncertainty in the foreign exchange markets as traders try to guess when and how strongly the central banks will intervene. Because the risk is that the dollar will decline, market participants may postpone purchases of dollars. But should the fear that central banks will intervene subside, the demand for dollars will increase and, other things remaining the same, the dollar might appreciate somewhat. As such, unless the recent intervention is seen as implying an increase in the central banks' willingness to intervene on a continuing basis, the immediate impact is likely to be considerably larger than the long-run impact.

A number of studies have shown that the effects of intervention alone are transitory at best. Longer run movements in exchange rates appear to be determined by fundamentals such as interest rate differentials. Thus, in the long-run, the effects of the G-5 meeting may depend crucially on the extent to which it leads to important changes in the international coordination of economic policies.

Market participants are becoming convinced that short-term measures, such as intervention, have achieved about as much as they are likely to. They feel that further adjustments in the exchange value of the dollar can be brought about only by changing fundamental economic conditions. In particular, they believe the time has come for the U.S. to take steps to reduce its federal budget deficit and for the Japanese and, perhaps, European governments to stimulate their economies through significant tax or expenditure changes. In the absence of such measures, we may already have seen the maximum impact of the decisions made at the G-5 meeting.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author. . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/20/85	Change from 11/13/85	Change from 11/21/84 Dollar	Change from 11/21/84 Percent[7]
Loans, Leases and Investments[1] [2]	197,218	– 11	10,032	5.3
Loans and Leases[1] [6]	178,852	429	10,325	6.1
Commercial and Industrial	51,249	46	– 1,109	– 2.1
Real estate	65,640	68	4,113	6.6
Loans to Individuals	37,804	– 10	6,975	22.6
Leases	5,416	18	365	7.2
U.S. Treasury and Agency Securities[2]	11,127	– 475	– 573	– 4.8
Other Securities[2]	7,239	35	281	4.0
Total Deposits	200,774	– 2,087	9,549	4.9
Demand Deposits	48,697	– 1,695	4,038	9.0
Demand Deposits Adjusted[3]	32,825	1,031	4,528	16.0
Other Transaction Balances[4]	14,252	– 176	1,850	14.9
Total Non-Transaction Balances[6]	137,826	– 216	3,661	2.7
Money Market Deposit Accounts—Total	45,804	35	6,114	15.4
Time Deposits in Amounts of $100,000 or more	37,889	– 663	– 2,854	– 7.0
Other Liabilities for Borrowed Money[5]	24,497	355	283	1.1

Two Week Averages of Daily Figures	Period ended 11/18/85	Period ended 11/4/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	40	25
Borrowings	19	17
Net free reserves (+)/Net borrowed(–)	21	8

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change